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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on the Exposure Draft ED/2010/1 *Measurement of Liabilities in IAS 37*. Principal authors of this comment letter are Josef Arminger, Christoph Krischanitz, Aslan Milla, Alexander Schiebel and Helmut Sorger.

General Remarks

In addition to our response to the three specific questions of the ED we would like to bring forward the following two concerns:

- First we urge the IASB to **re-expose** the entire proposed standard, not only the proposed measurement requirements. Although the IASB states in par. BC32 that it has thoroughly considered comments on the ED in 2005, and does not believe it needs to consider them again, we would like to accentuate that these comments were brought forward five years ago. Since then not only the business environment but also many IFRS have undergone significant changes (e.g. the financial crisis challenging standards like IAS 39 materially). Among them and of particular importance is the ED of a guidance on fair value measurement which will be finalised by the third quarter of

2010. We think that the public should have the possibility to see the entire proposed successor of IAS 37 in the light of these changes

Apart from that we believe because measurement objectives and methods on the one hand, and recognition criteria on the other hand are closely related, the IASB should re-expose the entire proposed standard: Many respondents to the ED in 2005 opposed – and continue to oppose – aspects of the proposals that the IASB is now re-exposing. The revised measurement proposals are significantly different from that of the original proposals and raise issues that were not aired in 2005. In our view, the IASB can, without significant delay, re-expose the proposed measurement requirements within the context of the proposed new standard as a whole, particularly due to the fact that the working draft of the standard is already available online.

- Second we see **missing guidance** on certain important aspects of the published ED. Apart from the aspects mentioned in our response to question 2, we ask the IASB for further guidance regarding the circumstances in which a **risk-adjustment** should be determined. In our view, it is not clear what the risk-adjustment is intended to represent. The adjustment could be interpreted as being for uncertainty about the extent to which the probability estimates are accurate. Also, it could be interpreted as a benefit for transferring the risk or as an additional safety margin. As far as a measurement objective is concerned, assessing liabilities with their expected value is only a merit at first glance as it is only consistent with risk aversion, which is empirically well founded, if adjusted for risk which is also recognized by the IASB in the BCs. However, the risk adjustment is highly subjective as it depends in essence on the nature of the liability and is derived from the utility function of the key operating decision maker assessing the liability.

  The nature of risks entails a distinctive treatment in the recognition and measurement of liabilities; consider liabilities that arise from a large number of similar risks like guarantee liabilities and liabilities arising from a single binary event like a lawsuit. The expected value in both cases signifies different degrees of information and, depending on the number of observable and comparable risks, the risk-adjustment will increase from risk neutrality to a high degree of risk aversion and subjective judgement. As such, in our view the lack of guidance is likely to result in significant diversity in practice.

Response to the specific questions in the ED

Question 1 – Overall requirements

The proposed measurement requirements are set out in paragraphs 36A-36F. Paragraphs BC2-BC11 of the Basis of Conclusions explain the Board´s reasons for these proposals. Do you support the requirement proposed in paragraphs 36A-36F? If not, with which paragraphs do you disagree, and why?

We basically agree with the IASB's objective to provide a single measure of liabilities within the scope of IAS 37 or the new IFRS [X] respectively, in order to improve consistency in application. Like the IASB we think that the option of cancelling or transferring the obligation to a third party will occur rarely in practice as opposed to the option of fulfilling the obligation. In our view this notion is captured by par. 36C by not requiring the entity to calculate the amounts of par. 36B (b) and (c) if there is no evidence that the entity could transfer or cancel an obligation at a lower amount than the one of par. 36B (a). We think that this warrants the application of a **„business model approach"** rather than the approach of fictitiously selling the obligation on the market. A „business model approach", in our view, is suitable for most of the liabilities within the scope of IAS 37 or the new IFRS [X] respectively. If the transfer of an obligation should be one of the measurement criteria we would expect a clear definition of the meaning of "transfer". In our understanding this should be a complete relieve of the obligation. There should also be an explanation of the relationship to the derecognition requirements of IAS 39.

Par. 36B (a) together with Appendix B prescribes the expected value of a probability distribution capturing all possible outcomes of fulfilling the obligation. In line with our agreement to the the IASB's objective to provide a single measure of liabilities within the scope of IAS 37 or the new IFRS [X] respectively, we agree with this requirement in case of the existence of **objective probability distributions** derived from statistical data that are applied to a large population of obligating events (e.g. legal or contractual warranty). We would, in principle, also agree with the expected value as the prescribed **benchmark measure** for all other probability distributions including **subjective probability distribution** based exclusively on management judgement referring to only one single obligating event (e.g. a law suit). But especially in cases like the last one we urge the IASB to re-deliberate the prohibition of any other measure. In our view there are sound reasons being provided by decision theory that make other measures such as the most likely outcome more appropriate especially for certain subjective probability distributions. We question the ability of an expected value to contain the maximum of available information of a probability distribution in conjunction with a theoretically consistent risk adjustment. Particularly in binary situations based on likelihoods rather than empirical probabilities, the expected value does not signify the most likely outflow of resources. By definition the likelihood that the expected value will represent the observable outflow of resources embodying economic benefit is close to nil. In such a setting alternative measures provide more meaningful information.

In order to provide investors, other capital providers and stakeholders with decision useful information an **allowed exception** from measuring at expected value must be regulated and accompanied by additional information in the notes: This additional information must at least name the (class of) obligation(s) not being measured at expected value, describe the reasons for doing so and, if not impracticable, display the expected value of the (class of) obligation(s). By doing so we believe that the investors and other capital providers are even provided with more decision useful information than they are by measuring certain obligations at expected values in the statement of financial position contradicting decision theory.

Apart from the exception from measuring at expected value that we favour for certain probability distributions being described above, we again emphasise the material differences between objective probability distributions derived from statistical data that is applied to a large population of obligating events (e.g. legal or contractual warranty) and **subjective probability distributions** based exclusively on management judgement referring to only one single obligating event (e.g. a law suit): Whereas the expected value of the former distribution is practically certain if the large population of obligating events allow for a reasonable spread of risks (i.e. the deviations from the expected value with reference to the obligating events tend to offset each other), this does not hold true for the latter distribution. Consequently, the probability of no future obligation being part of all possible outcomes of a subjective probability distribution may be material. Contradicting the necessary reliability of liability measures, this may enable entities to actively manage earnings by recognising liabilities the fulfilment of which will possibly not result in an outflow of resources embodying economic benefits. Therefore, we propose to prescribe a **probability threshold** of 50% for the recognition of liabilities being based on subjective probability distributions. This would mean that the probability of an outflow of resources embodying economic benefits must exceed the threshold for the liability to be recognised. In turn, we propose not to derecognise the liability if the threshold is no longer exceeded when subsequently measuring the liability as long as the probability of an outflow of resources embodying economic benefits is not remote. The advantage of a threshold, in our view, is on the one hand the reliability of liability measures based on subjective probability distributions (preventing excessive earnings management) and on the other hand the provision of decision useful information: The investors, capital providers and other stakeholders are informed about those liabilities only if the risk of an outflow of resources embodying economic benefits has exceeded the threshold and thus, has become more likely than not. When using present value calculation for the measurement of a liability we would expect guidance concerning the components to be included in the interest rate used. We would particularly welcome guidance that clarifies how to deal with "own credit risk" when determining the relevant discount rate.

Question 2 – Obligations fulfilled by undertaking a service

Some obligations within the scope of IAS 37 will be fulfilled by undertaking a service at a future date. Paragraph B8 of Appendix B specifies how entities should measure the future outflows required to fulfil such obligations. It proposes that the relevant outflows are the amounts that the entity would rationally pay a contractor at the future date to undertake the service on its behalf. Paragraphs BC19-BC22 of the Basis for Conclusions explain the Board´s rationale for this proposal. Do you support the proposal in paragraph B8? If not, why not?

We agree with the IASB´s aim to objectify the measurement of liabilities by requiring the use of prices the entity would rationally pay a contractor to undertake the service on its behalf. In our view, this **„outsourcing fiction“** is able to make the measurement more reliable in those cases where prices are readily available in markets or where comparable prices can be determined objectively and not arbitrarily.

With regard to such a determination of prices we have concerns that the reliability the IASB is aiming at is materially damaged by the **missing guidance** on the following issues:

- Par. B8 (a) refers to a **market** from which the price of the service should be derived. A price can be derived from an active market or just by inviting offers from a few possible contractors. Is the market notion comparable to the market notion of other IFRS (e.g. IFRS 9)? Until now there is no guidance about what constitutes a market and whether the referenced market should be a liquid market with observable market prices.

- There is also no guidance about how to determine the **margin** when there is not a market for the service (see par. B8 (b)). This lack of guidance will lead to unacceptably wide variation in the margins that different entities include for similar obligations and provide a means of earnings management which in our view impairs the overall aim of reliable and decision useful information.

In light of these concerns we question whether in the absence of any market entities should include a margin when they measure the value of resources necessary to fulfil the obligation. In this case, including a margin leads to a return on the resources used that does not represent a future outflow. We therefore to a certain extent share the concerns expressed in the alternative views by the dissenting IASB members. To include in all cases a hypothetical margin in the measurement of a liability reduces the profit at inception and releases a profit when the liability is settled. This may create inappropriate performance information.

We therefore suggest first to require an entity to identify whether a market and/or prices can be objectively identified and to use those prices even if the entity envisages fulfilling the obligation itself, pro-

vided that the third party prices are lower than the present value of the costs the entity will have to incur to fulfil the obligation. If the entity's costs are lower than comparable (market) prices then the "lower of notion" should be followed, i.e. using the entity's full, not incremental cost (without implicit profit margin) to determine the liability. Finally we would favour that the final standard contains a definition of costs applicable to those circumstances so as to avoid further diversity in practice.

Question 3 – Exception for onerous sales and insurance contracts

Paragraph B9 of Appendix B proposes a limited exception for onerous contracts arising from transactions within the scope of IAS 18 Revenue or IFRS 4 Insurance Contracts. The relevant future outflows would be the costs the entity expects to incur to fulfil its contractual obligations, rather than the amounts the entity would pay a contractor to fulfil them on its behalf. Paragraphs BC23-BC27 of the Basis for Conclusions explain the reason for this exception. Do you support the exception? If not, what would you propose instead and why?

We do not agree with the **limited exception** for onerous contracts arising from transactions within the scope of IAS 18 or IFRS 4. In our view, it is not acceptable that the IASB does not apply the rule developed by par. B8 to all comparable transactions equally within the scope of IAS 37 or the new IFRS [X] respectively including the before mentioned contracts. We cannot imagine reasons why the ongoing projects of revenue recognition and insurance contracts could possibly deviate from the conclusions drawn in par. B8. And if they, contrary to our expectations, we do not see a valid reason for a scope exclusion in the successor IFRS [X] of IAS 37. We urge the IASB to either make a decision and apply this decision to all comparable transactions within the scope of IAS 37 or the new IFRS [X] respectively or to postpone the decision drawn here until the ongoing projects of revenue recognition and insurance contracts are aligned with the conclusions of the successor IFRS [X] of IAS 37.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman